

## Tax Talk Presents: Federal Tax Changes

The new federal tax law has become the hot topic for the Tax Talk seminar to be telecast on October 7.

At press time, Tax Talk producers were putting together a new program segment to tell you what you need to know now about the most massive tax reform since 1986.

The Tax Talk presentation on the new federal tax law, signed by the President on August 5, will concentrate on changes that affect 1997 tax returns. An Internal Revenue Service

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## Advice for Growing Limited Liability Company Population

Limited liability company (LLC) registrations in California are on the rise, and so are some misunderstandings about when and how to satisfy an LLC's tax filing and payment obligations.

Currently, about 31,000 LLCs are registered here. LLCs are registering at the rate of approximately 1,100 per month, a jump from a former 400 to 500 registrations per month.

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## Viewing for Credits



*The new Tax Talk video series lets you earn continuing education credits without leaving your home or office. For more information, see "Tax Talk: Earn Credits Three Ways" on page 3.*

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## Tax News

Volume 97-5 September 1997

**TAX NEWS** is a bimonthly publication of the Taxpayer Advocate Bureau, California Franchise Tax Board. Its primary objective is to provide information to income tax practitioners about state income tax laws, regulations, policies and procedures.

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## Nonfilers Have Questions

More than 650,000 people have not filed California personal income tax returns even though they appear to have income from a California source.

When the Franchise Tax Board sends notices to these nonfilers, a number of them respond with questions. To help you reply to similar queries from your clients, here are three of the most frequently-asked questions, along with the answers:

### **I don't live in California. Why do I need to file a California personal income tax return?**

The law requires you to file if you receive income from a California source, no matter where you live. For example, people who live and work in Kansas must file a California return if they receive money from the sale of property in California or compensation for any work performed in California.

### **Why did FTB send me a notice asking me to file a California income tax return when I already did so?**

You may have put the wrong Social Security number on the return by mistake. Or perhaps FTB made an error in recording the number. So, even though you filed the return, FTB has no record of one under your correct Social Security number.

You can verify whether FTB has received your return by calling an interactive voice response telephone service at (800) 545-5009. You should have your copy of the return with you so that you will have all the information at hand. You can call the service seven days a week, except state holidays, from 6 a.m. to 8 p.m. The service also can supply answers to other questions about the notice you received from FTB.

If your return is not located as a result of the telephone call and your Social Security number was listed correctly, mail a copy of the return to the address given on the notice that FTB sends you.

### **I received a Notice of Proposed Assessment for failing to filing a return. May I still file my return?**

Yes. In fact, the law requires you to file the return, even if you pay the proposed assessment in full. Then, after FTB

receives and processes your return, it will adjust the tax and penalties based on the correct amount of tax that you owe. If you have other questions about a Notice of Proposed Assessment, call FTB at (800) 895-5440. □

## Corporations: Take Credit Where Credit Is Due

The Franchise Tax Board has developed seven guidelines to help corporations and S corporations enter complete and accurate credit information on California tax forms.

Corporate tax forms now use codes, similar to codes used on personal income tax forms, to identify credits that are claimed on tax returns. The codes were introduced on the 1995 Form 100, "California Corporation Franchise or Income Tax Return," and Form 100S, "California S Corporation Franchise or Income Tax Return."

Businesses now must identify each credit by its name, credit code and amount. The entries are made on lines 23 through 25 on Form 100 and on lines 22 through 24 on Form 100S. If a business has more than three credits, it should use the next line, which states "To claim more than three credits..." for the total amount of the additional credits.

To make sure that credit information is entered correctly, businesses should:

- Enter a credit code only once. If a business uses one credit in more than one section of Schedule P, "Alternative Minimum Tax and Credit Limitations - Corporations," it should total the amounts for that credit and enter the credit's code on the return only one time. For more information, see "How to Claim Credits" on the Schedule P (100) instructions.
- Enter an amount on the "To claim more than three credits..." line only if the three preceding credit lines are filled and more credits are claimed.

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## Coming Up Fast: Tax Talk Discount Deadline

Time is running out. But you can still sign up for the October 7 Tax Talk seminar at a discounted fee.

If your registration form and payment are postmarked no later than September 19, you can attend the seminar for \$150. If you register later, the fee is \$195.

Tax Talk is a program of the nonprofit Center for Tax Education. It is presented by the California Franchise Tax Board, Employment Development Department, Internal Revenue Service, State Board of Equalization and the School of Business Administration at California State University, Sacramento.

If you attend the all-day seminar (see article at the far right for locations), you can earn up to eight continuing education credits toward the requirements of the California State Board of Accountancy; the California Tax Education Council, which replaced the Department of Consumer Affairs' Tax Preparer Program in July; and, for enrolled agents, the Internal Revenue Service.

Topics at this year's seminar are:

- "General Partnerships: What's In It For Me?" tells how to form a partnership and why your clients might want to.
- "Sales Tax: Compliance or Confusion?" looks at common sales tax reporting errors and how to avoid them.
- "Experience Rating System: What You Don't Know Could Cost You" shows how to lower your clients' unemployment insurance taxes and what affects the unemployment insurance rate.
- "Trusts: Are Your Trusts Worthy?" will help your clients understand why they should avoid abusive trust schemes.
- "Alternate Filing Methods: The Wave of the Future" is a crystal-ball guide to ways of filing tax returns in the future.
- "Penalties: Read the Fine Print" explains when and why penalties from the four participating tax

agencies are assessed.

- "Employment and Excluded Services: Are You Paying More Taxes Than Required?" reports on the employment services that are exempt from employment taxes and answers related questions.

To register for Tax Talk at a discounted fee, mail your registration form and fee right away. The form was mailed to Tax News subscribers in June and again in August. If you no longer have the form, you can obtain a substitute one by calling (916) 845-7070. □

## Tax Talk: Earn Credits Three Ways

Now you have three ways to earn continuing education credits from Tax Talk.

A day-long seminar, telecast live each year to 20-plus locations in California, Nevada and Oregon, is the original Tax Talk component. It will be presented this year on Tuesday, October 7 (see article on this page). You can earn up to eight hours of continuing education credit by attending the seminar.

Spin-offs of the seminar include:

- **Tax Talk Home Study Course.** If you cannot attend the seminar on October 7, you can still earn up to eight hours of credit by taking the home study course. The course includes a video of the seminar, a textbook and a test. It will be

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expert will discuss, among other things, the capital gains tax, home sales, the earned income credit and the child credit.

For more information on Tax Talk, see the articles on this page. □

## Tax Talk: Coming to a Location Near You

Tax Talk, the educational seminar on October 7, will be telecast to 22 locations in California and one each in Nevada and Oregon.

In California, you can attend Tax Talk in Anderson, Bakersfield, Del Mar, Eureka, Fresno, Indio, Irvine, Long Beach, Los Angeles, Monrovia, Monterey, Pleasanton, Riverside, Sacramento, San Jose, Santa Barbara, Santa Rosa, South San Francisco, Stockton, Vallejo, Van Nuys and Ventura. Tax Talk also will be telecast to Reno, NV, and Ashland, OR. □

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## Schedule K-1: Tips on Filing, Avoiding Errors

### *Need a Speaker?*

If your professional or community organization is interested in information about California tax laws and administrative procedures, the Franchise Tax Board has a speaker for you.

To make sure that a speaker will be available for your event, call the FTB Speakers' Bureau four weeks in advance. The number is (916) 845-5257.

For more information, see the May 1997 Tax News.□

Do you prepare partnership returns? And would you like to save time and money?

Last year, 52 partnerships did just that by filing more than 900,000 Schedule K-1s (565) on diskette or magnetic media instead of printing and mailing paper copies to the Franchise Tax Board.

When you send K-1 information to FTB by diskette or magnetic media, all you need to print and mail is the Form 565 return.

To learn everything you need to know about the process, read FTB Publication 1062, "Guide for K-1 (565) Filing by Diskette or Magnetic Media." If you have Internet access, you may download, view and print Publication 1062 and other California tax publications and forms. Contact FTB at its <http://www.ftb.ca.gov> Internet address. You also can get a free copy of the publication by calling FTB's Taxpayer Services Center at (800) 852-5711. However, after January 1, 1998, call F.A.S.T. (Fast Answers about State Taxes) at (800) 338-0505 for a copy of the publication.

If you are filing partnership returns under the automatic extended deadline, you may be able to avoid some of the errors that others have made if you are sure to fill in:

- Either the state or foreign country field. If the address is in a foreign country, you can either type a period (.) in the state field, as the Internal Revenue Service program specifies, or merely leave the state field blank. If the address is in this country, leave the foreign field blank.
- The address, city and state fields, if the address is in this country. You must enter something in each of these fields, and the state field must contain a valid two-character postal abbreviation for a state, such as "CA" for "California."
- All 12 characters in the money amount fields. You can use a positive amount without a plus sign (000000002333), a negative amount

with the minus sign counting as one of the characters (-00000002333) or all zeros (000000000000).

- All seven characters plus the decimal point in the percentage fields. All percentage fields must have either the percentage amount (.0500000) or all zeros (.0000000) following the decimal point.□

### *Tax Talk: Earn Credit Three Ways*

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available in December but must be ordered by November 14. The cost is \$150. Only one person may use the test portion of the course package, but you can order additional tests for associates for \$35 each.

- **Tax Talk Continuing Education Video Series.** The first entries in the series are "Office-in-Home Deductions" and "California Tax Rules for Nonresidents." Both are updated adaptations of previous seminar presentations. Each costs \$60 for a one-hour videotape, textbook and workbook. Also included is a brief, "open book" examination, which you can take to earn three continuing education credits. The videos may be ordered at any time and will be shipped this fall.

The registration form for the Tax Talk seminar doubles as an order form for the home study course and video series. The form was mailed to all Tax News subscribers with a Tax Talk brochure in June and again in August. If you have misplaced the registration/order form, you can obtain another copy by calling (916) 845-7070.□



## Part 2

# Trusts: Too Good to Be True?

Taxpayers should be careful about putting their trust in trusts.

That's the message behind the Internal Revenue Service's Notice 97-24. The notice warns that some trusts are set up to reduce income tax illegally. They abuse the tax codes by unlawfully inflating expenses, deducting personal expenses or both.

The Franchise Tax Board and the IRS are working together to identify abusive trusts. And they are encouraging taxpayers who have participated in

abusive trust arrangements to adhere to the law voluntarily. In order to comply, taxpayers should file correct tax returns this year and file amended tax returns for other years that they participated in abusive trust arrangements.

For more information, attend the IRS presentation of abusive trusts at the Tax Talk seminar on October 7 (see "Coming Up Fast: Tax Talk Discount Deadline" on page 3). For an adaptation of parts of the notice, see box below. Also see the July 1997 Tax News for Part 1 of this series. □

## Trusts: Internal Revenue Service Notice 97-24

*The following summary includes portions of Internal Revenue Service Notice 97-24. For specific application, refer to the entire text of the notice. Additional information was published in the July Tax News.*

Trusts have many legitimate uses. They are lawfully used in estate planning, to aid in legitimately transferring property to charities and to hold property for minors or for people declared incompetent. Under the tax laws, either the trust, the trust beneficiary or the transferor must pay tax on the income that the trust realizes.

Abusive trusts, however, attempt to transform a taxpayer's personal, living or educational expenses into tax deductions. They try to avoid tax liabilities by ignoring either the true ownership of income and assets or the substance of transactions.

Also, in an abusive trust arrangement, the original owner of the trust's assets in effect has the authority to take direct or indirect advantage of the trust's financial benefits. For example, the trust promoter or a friend or relative of the owner may be the trustee and carry out the owner's instructions even if they are

not permitted by the terms of the trust. The trustee may give the owner checks along with a rubber stamp of the trustee's signature, signed checks or a credit or debit card, so that the owner can obtain cash or use the trust's assets for his or her benefit.

The results that abusive trust promoters promise are not allowed by law. Although promoters of abusive trust arrangements may say otherwise, trusts are governed by four well-established tax principles:

- **Substance, not form, controls taxation.** The U.S. Supreme Court has consistently stated that the substance of a transaction, not its form, is controlling for tax purposes. As a result, trust arrangements that attempt to circumvent tax laws are treated as sham transactions.
- **Grantors may be treated as trust owners.** Grantor trust rules say that someone who transfers property to a trust and who keeps an economic interest in the trust or control over it

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## FTB Calendar

### September

- 1 Processing and suitability checks begin for electronic filing applications.
- 15 Personal income tax estimate payments are due.
- 19 Last day to mail Tax Talk registration form and payment to qualify for discounted fee.
- 20 Previous month withholding at source payments are due if total withholding exceeded \$2,500.
- 27 Orange County Small Business Tax Day, California State University, Fullerton.
- 31 FTB Publication 1345, "Electronic Filing Handbook, File Specifications and Record Layouts for State of California Individual Income Tax Returns," is mailed to software developers, with subsequent updates posted on FTB's Internet site. (Also see December listing.)

### October

- Requests for 1995 tax returns mailed to corporations.
- 4 San Diego County Small Business Tax Information Day, Point Loma Nazarene College.
- 7 Tax Talk seminar held.
- 15 Final extended due date for personal income tax returns.
- 18 Van Nuys Small Business Fair, Los Angeles Valley College.
- 20 See September 20.
- 25 Inland Empire Small Business Tax Day, Riverside.

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## Phone Line Heats Up

First, the Franchise Tax Board's Tax Practitioner's Hotline was incorporated into the Tax Practitioner Support Unit. Then, the telephone number was changed to one that gave you greater access. But no matter what it's called or how it has changed, the phone line is still "hot." The effort to provide greater telephone access may have been too successful. You and/or lots of your peers responded by picking up the phone. As a result, the program currently is seriously "taxed."

In June, the Tax Practitioner Support Unit staff took 7,838 calls. The average number of monthly calls to the unit used to be about 6,000. Also in June, the unit received 642 faxes, all requesting answers to questions. In the past, the average was about 200 faxes per month.

FTB is looking into ways to relieve the situation. One consideration is to find a new way to handle requests for taxpayer information from previous tax years. These requests often require considerable research and divert staff from handling other phone calls.

If the next calls you plan to make to the Support Unit are not urgent, you might consider putting them off until later. And while you exercise patience, watch upcoming issues of Tax News for reports on how FTB will meet the challenge. □

## The Question Column

### How closely does California conform to federal depreciation rules?

California depreciation statutes are divided between two separate bodies of law. One deals with individuals and one with banks and corporations. Under the personal income tax law, California conforms to the federal Modified Accelerated Cost Recovery Depreciation System (MACRS).

California Revenue and Taxation Code Section (R&TC) 17201 incorporates Internal Revenue Code (IRC) Section 167 (a) for purposes of the personal income tax law. As a result, California allows individuals to claim a depreciation deduction on certain kinds of property used in a trade or business or in producing income.

The phrase "used in a trade or business" generally is interpreted to mean devoted to a trade or business. If only part of the property is used for business purposes or if the entire property is used only partly for business purposes, the deduction must be an apportionment according to the percentage of the basis that is attributable to business use.

The California bank and corporation law does not conform to federal MACRS depreciation schedules. Instead, it uses the mid-range of the Class Life Asset Depreciation Range system to determine the economic useful life of depreciable assets.

Property is considered eligible for depreciation if it is subject to wear and

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## Trusts: Internal Revenue Service Notice 97-24

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is treated as the owner of the trust property for income tax purposes. In addition, all trust transactions are treated as the owner's transactions. As a result, the owner must report all trust expenses and income, and any tax deductions and losses that arise from transactions between the owner and the trust are ignored. Also, no taxable "exchange" of property between the grantor and the trust is possible, and the tax basis of property transferred to the trust is not stepped-up for depreciation purposes.

- **Personal expenses generally are not deductible.** Personal expenses such as home maintenance, education and personal travel costs are not deductible unless tax laws expressly say so. The courts have consistently held that taxpayers

cannot use trusts to transform non-deductible personal expenses into deductible expenses. Also, the costs of creating the trust are not deductible.

- **A genuine charity must benefit in order to claim a valid charitable deduction.** Tax law carefully defines charitable trusts that are exempt from tax. Trust arrangements that do not conform to the law, including the requirement that the true purpose is to benefit charity, are not exempt charitable trusts. Also, supposed charitable payments made by a trust are not deductible charitable contributions when the payments really benefit the owner or the owner's family members. □

## 1997 Scannable and Substitute Forms Producers Need FTB Approval

Are you planning to use scannable or substitute 1997 state tax forms?

If so, make sure they meet the Franchise Tax Board's requirements. Otherwise, the software you use may produce forms that cannot be processed quickly. Processing problems are especially likely to happen when unapproved Schedule K-1 forms are filed.

All companies that publish, produce or sell electronically-processed substitute California tax forms or image-processed scannable Forms 540 and 540A must file an agreement to comply with FTB requirements for the forms. Also, FTB must approve the forms before they are sold or provided to tax preparers. Companies that sell or provide photocopies of official FTB forms do not need approval.

To date, the companies listed below have filed form FTB 1096, "Agreement to Comply with FTB Publication 1098" for the 1997 tax year. The form states that the companies agree to follow certain rules for developing scannable and substitute forms. Filing form FTB 1096, however, does not constitute approval from FTB.

Be sure to ask a company to show you FTB's letter of approval before you use its forms. Do not accept a general statement that the forms have been approved. Instead, give the company a list of the forms you plan to use, and make sure that each one is approved.

Companies that have filed form FTB 1096 to date are:

Accountant Stationers & Printers  
(800) 423-9717

Accountware (513) 561-1881  
AM Software (816) 741-7848

Arthur Andersen LLP (941) 365-9469  
ATX Forms (207) 455-4848

Block Financial Corporation (Tax Cut)  
(913) 599-2885

Brass Tax Presentations (619) 487-2553

BSoft Corporation (408) 438-7071

CCH Federal and State Tax Unit

CCH Incorporated (Torrance) (310) 543-6200

CCH Incorporated (Wichita, KS)  
(316) 685-8100

CLR/Fast Tax (800) 327-8829

CompuCraft Tax Services (800) 435-7829  
Consolidated Business Systems  
(800) 262-4461

CPASoftware (800) 434-2685

CPSystems, Inc. (804) 346-0640

Creative Solutions Inc. (313) 426-5860

Curtis Publications Inc.

Dave Gomberg's JCF Systems  
(415) 731-7793

DRAKE Software (704) 524-8020

EXACTAX Inc. (800) 352-3638

Federated Tax Service Inc.

Hambrecht & Quist (415) 576-3300

H&R Block/Tax Systems Development  
(816) 753-6900

Independent Preparer Services, Inc.  
(818) 701-3090

Inland Society of Tax Consultants

Intuit, Inc. (619) 784-4274

ITS, Inc. (800) 487-8291

Jackson Hewitt Tax Service (757) 473-3300

KPMG Peat Marwick LLP

MAVERICC Management Systems  
(248) 614-4500

Mercury Printing and Stationery Co.  
(800) 421-2220

Micro Vision Software, Inc. (800) 829-7354

Nelco, Inc. (920) 337-2848

ORRTAX Software (800) 377-3337

Pencil Pushers Tax Software (617) 273-4556

PETZ Enterprises, Inc. (209) 835-2720

Professional Stationers Inc. (800) 874-7383

Probate Software Co., Inc. (970) 330-3260

RealNet Software, Inc.

Reynolds & Reynolds (formerly Duplex  
Products, Inc.) (408) 934-8540

Spidell Publishing Inc. (714) 776-7850

STF Services Corporation (800) 541-7197

Tax And Accounting Software Corporation  
(800) 998-9990

Tax Form Library (800) 466-9110

Tax Forms, Inc.

Tax Systems, Inc. (713) 682-1791

TAXBYTE, Inc. (800) 245-8299

Taxware Systems, Inc. (800) 877-1065

Taxworks by Laser Systems (801) 552-8800

TFP Data Systems

TK Publishing Inc. (Tax Shop)  
(407) 351-0966

TMI Tax Services, Inc. (612) 935-6111

Total Peripherals, Inc.

Universal Tax Systems (706) 232-7757

Visible Computer Service (630) 377-2586

Wallace Computer Service (630) 377-2586

Weaver Tax Service (408) 258-0912

Westpro LTD

XPRESS Software, Inc. (800) 285-1065 □

## Tax Statistics on the Internet

The Franchise Tax Board's "1995 Annual Report" is now on the Internet.

If you want to browse through statistical information about more than 12 million individual and corporate tax returns, contact FTB at its <http://www.ftb.ca.gov> Internet address. The report also has information on legislation and legal matters. □

## FTB Calendar

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### November

- 7 1997 Package X order forms are distributed as part of Tax News.
- 14 Last day to mail payment and order for Tax Talk Home Study Course.
- 20 See September 20.

### December

- FTB Publication 1345, "Electronic Filing Handbook, File Specifications and Record Layouts for State of California Individual Income Tax Returns," is available to tax practitioners.
- 1 Deadline for electronic filing applications.
- 20 See September 20.
- 26 1997 personal income tax forms are mailed. □

## ***Interested in Legislation?***

If you are interested in a particular bill being considered by the California Legislature, you can obtain a copy by mail or from cyberspace.

You can request a copy of the bill you would like to read from an office at the state capitol. Write the Legislative Bill Room, Room B-32, State Capitol, Sacramento, CA 95814. Or call the Bill Room at (916) 445-2323.

If you have Internet access, you also will find legislative measures at <http://www.leginfo.ca.gov>, which is the Official California Legislation Information Web site address. □

## ***The Question Column***

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tear, decay or decline from natural causes, exhaustion or obsolescence. To be eligible, the property also must have a useful life of more than one year.

Improvement costs are capitalized and depreciated. Repair costs, on the other hand, are deductible as expenses. A repair keeps the property in good operating condition and does not materially add to the property's value or substantially prolong the property's life. Examples of repair costs are repainting the property inside and out; fixing leaks, floors and gutters; and replacing broken windows.

California also generally conforms to IRC Section 179's methodology. However, the IRC section currently allows individual taxpayers to elect to expense, up to \$18,000 per year, the cost of certain eligible personal property used in actively conducting a trade or business. California R&TC Section 17255 currently allows up to \$12,500 per year. The deduction is limited to "business income," which includes, among other things, wages, salaries, tips and other compensation that an employee earns. Both the federal and California deduction amounts will increase in future years.

**A police officer is required to purchase his own handgun, which costs \$500. Can the full amount be claimed as a miscellaneous employee expense, subject to the 2 percent floor, on Schedule A? Or should the officer depreciate the \$500?**

If a taxpayer can show that either an employer or the necessities of the job, not personal preference, requires a handgun, the cost of the gun and the expense of maintaining it qualify as deductible business expenses under IRC Section 162 as it is incorporated into California law.

So, the police officer may elect to deduct the \$500 cost under IRC Section 179 on Internal Revenue Service form 4562, "Depreciation and Amortization," flow through to IRS form 2106, "Employee

Business Expenses," and then deduct the full \$500 on Schedule A, "Miscellaneous Employee Expense," subject to the 2 percent floor.

**A photographer is a Schedule C filer. What is the recovery period for a camera costing \$800?**

A camera does not qualify as eligible personal property under IRC Section 179.

However, if the camera has a useful life of more than one year, its cost may be deducted proportionally over its estimated life. Also, if the camera is used for both business and nonbusiness activities, the photographer must apportion the purchase amount accordingly. The photographer may use the MACRS General Depreciation System over five years, subject to an alternative minimum tax (AMT) adjustment. Or the photographer may use the MACRS Alternative Depreciation System over 9.5 years, which is not subject to an AMT adjustment.

**A taxpayer has a rental house that is separate from the taxpayer's residence. The rental needs a new septic system. What is the recovery period for the septic system, if the rental house is being depreciated under MACRS at 27.5 years?**

A new septic system adds materially to the value of the property, so it is considered an improvement. The depreciation deduction for an improvement is figured in the same way as the deduction for the property. The starting point for the depreciation begins on the date that the improvement is placed in service because the rental house is already being depreciated. Since the taxpayer elected MACRS, the septic system is depreciated as residential rental property at 27.5 years.

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## FTB Collects Defaulted Student Loans

State law now requires the Franchise Tax Board to use its collection expertise to help collect defaulted student loans.

Assembly Bill 255 (Speier - Ch. 96-1001) created a partnership between the California Student Aid Commission (CSAC) and FTB to collect the defaulted student loans. The partnership got under way in July.

The collection process involves CSAC, private collection agencies and FTB. When a former student defaults on a loan, CSAC sends the debtor a notice of the amount due. If the debtor fails to pay the full amount by the due date, CSAC sends three additional notices approximately 30 days apart. CSAC also telephones the debtor several times during the period that notices are issued. The last notice tells the debtor that the loan will be referred to a private collection agency. Then, if the private collection agency does not collect from the debtor within nine months, CSAC may refer the defaulted loan to FTB.

As a result, loan cases usually have been in default for at least one year by the time they are referred to FTB. However,

unlike some debts, defaulted student loans often become more collectible with age as the former students enter and establish themselves in the job market.

FTB's first collection action is to issue a Demand for Payment bill requesting payment. If the debtor does not pay the loan within 10 days, FTB may then take the same kinds of actions that the law permits it to take in collecting delinquent personal income tax liabilities. For example, it may levy bank accounts and wages.

The first FTB Demand for Payment bills were sent to approximately 30,000 debtors in July. This month and in August, FTB sent additional Demand for Payment bills and began placing levies on bank accounts and wages of debtors who did not comply. FTB expects to collect \$20 million during its first year in the program, \$45 million in the second year and \$55 million in the third year.

If FTB contacts any of your clients about a defaulted student loan and if the clients have questions, they can call FTB at (916) 845-5775. □

### *The Question Column*

CONTINUED FROM PAGE 8

**A taxpayer rents out the second floor of his residence and depreciates it under MACRS at 27.5 years. The residence needs a new roof. What is the recovery period for the rental portion of the roof?**

Like the new septic system described in the previous answer, a new roof adds materially to the value of the property and is considered an improvement. The depreciation deduction for an improvement is figured in the same way as the deduction for the property. The starting point for the depreciation begins on the date that the improvement is placed

in service because the second floor of the residence is already being depreciated. Because the taxpayer elected to depreciate under MACRS, the new roof is depreciated as residential rental property at 27.5 years. The allocation formula would be the same as the one being used for the second floor of the residence.

*If you have a question for The Question Column, send it to Editor, Tax News, Franchise Tax Board, P.O. Box 520, Rancho Cordova 95741-0520. □*

## *Collections Information Is Just a Fax Away*

Do you have a question about personal income tax collections? Now, the Franchise Tax Board can provide a fast answer via a new fax Help Line for tax practitioners only.

Starting this month, you can fax FTB both your general personal income tax collections questions and queries about collections activity involving a specific client. The new collections Help Line fax number is (916) 845-0494.

The fax line is open 24 hours a day, seven days a week. □

## *Renew Tax News*

Keep the tax news coming with Tax News.

When your subscription to Tax News is about to run out, the Franchise Tax Board will send you a renewal notice.

Be sure to return the notice right away so that you will not miss any upcoming issues. □

## ***Package X Order Form Coming in November***

Watch the November issue of Tax News for a 1997 Package X order form.

The order form will appear on the last page of the November issue. You will be able to order the Package X in either a paper form or on CD-ROM.

If your Tax News subscription is about to end, the expiration date will be noted on the form so that you may renew your subscription. □

# **Program Set for Tax Practitioners' Institute**

The Tax Practitioners' Institute's fall program is a three-day presentation of federal and California tax information.

The federal portion of the program this year includes information on sham trusts, tax liabilities and innocent spouses, real estate professionals and passive activity losses/credits, IRAs, new laws and changes to Internal Revenue Code Section 104, which deals with compensation for injuries and sickness, after the 1996 Tax Act.

The state program covers differences between federal and state tax laws that affect both individuals and corporations, credits against tax and a legislative update.

By attending the Tax Practitioners' Institute, you can qualify for up to 24

hours of continuing education credit toward the requirements of the California State Board of Accountancy; the California Tax Education Council, which replaced the Department of Consumer Affairs' Tax Preparer Program in July; and, for enrolled agents, the Internal Revenue Service. So far, the Institute is scheduled for eight Northern California locations and San Diego with additional Southern California sites planned (see article on this page).

Institute sponsors are the California State University, Chico, Fresno, Hayward and Sacramento; Humboldt State University; San Diego State University; the University of California, Santa Cruz; the Franchise Tax Board; and the Internal Revenue Service. □

## **Tax Practitioners' Institute Adds Southern Sites**

For the first time, the Tax Practitioners' Institute will hold its three-day program at Southern, as well as Northern, California locations.

The Institute's program (see article on this page) will be available at eight Northern California sites. By press time, one Southern California location had been added, and others will follow.

For enrollment, registration and other information, call the telephone number listed below at the Institute site nearest you.

In Northern California, Institute programs are scheduled for:

**Fresno:** November 6 - 8  
(209) 278-5663

**Sunnyvale:** November 10 - 12  
(408) 342-0236

**Sacramento:** November 12 - 14  
(Initially, this Institute was scheduled earlier in the month)  
(916) 278-6346

**Chico:** November 17 - 19  
(916) 898-6105

**Shell Beach:** November 20 - 22  
(408) 342-0236

**Oakland:** December 1 - 3  
(510) 881-2312

**Monterey:** December 4 - 6  
(408) 342-0236

**Arcata:** December 11 - 13  
(707) 826-3731

In Southern California, you can attend the Institute in:

**San Diego:** November 5 - 7  
(619) 594-6255

For additional Southern California sites, call the Center for Management Services, School of Business Administration, California State University, Sacramento at (916) 278-6346. □

## Limited Liability Companies

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One of the reasons for the increase may be a change in the kinds of taxpayers that may qualify as LLCs. The 1994 law that authorized the formation of LLCs in California excluded professional services for which either the Business and Professions Code or the Chiropractic Act require a license, certification or registration. However, subsequent legislation now allows previously excluded insurance brokers and agents to form LLCs. And the Legislature is considering several bills that would allow other excluded businesses, such as real estate brokers and contractors, to form LLCs under certain circumstances including carrying a minimum bond or insurance for consumer liabilities.

As more taxpayers register as LLCs, misunderstandings about tax requirements are emerging. If you have LLC clients that are classified as partnerships, provide them with these reminders:

- They must pay an \$800 tax each year for the privilege of doing business in California. Some companies fail to make their initial payment on time; they mistakenly pay the \$800 tax the following year when their return is due.

This tax is due each year on the 15<sup>th</sup> day of the fourth month of the LLC's taxable year, which is April 15 for companies that file on a calendar-year basis. If an LLC organized in another state registers with the California Secretary of State or begins doing business here after the date for paying the \$800 tax, the amount is due immediately. LLCs should send the \$800 tax to the Franchise Tax Board with Form 3522, "Limited Liability Company Tax Voucher," not with their tax return.

For example, an LLC that registers with the California Secretary of State or that begins doing business in California on January 1, 1997, must make its initial \$800 tax payment with Form 3522 by April 15, 1997. However, an LLC that organized in another state and that registers with the California Secretary of State on June 15, 1997, which is after the

April 15 due date, must pay the \$800 tax with Form 3522 either upon registration or on the date it started business, whichever is earlier. Whether a calendar-year LLC registers before or after April 15, 1997, its 1997 return is due on April 15, 1998, with payments for the annual fee and any nonconsenting members' tax that is due. The 1998 \$800 LLC tax payment also is due on April 15, 1998; it should be mailed with Form 3522, not with the tax return.

- They must file their tax returns on Form 568, "Limited Liability Company Return of Income." Because the Internal Revenue Service requires LLCs to file using a partnership return, Form 1065, some LLCs are filing California returns on Form 565, "Partnership Return of Income," by mistake.
- In addition to the \$800 annual tax, LLCs must pay an annual fee with Form 568. The fee is based on "total income for the taxable year from all sources reportable to California." "Total income" is defined as gross income, plus the cost of goods, from all sources before taking into account apportionment and allocation. Use Schedule Q on Form 568 to compute this income.  
  
For taxable years beginning on or after January 1, 1996, the annual fee is \$500 if the total income is at least \$250,000 but less than \$500,000. The fee is \$1,500 if the total income is at least \$500,000 but less than \$1 million, \$3,000 if at least \$1 million but less than \$5 million, and \$4,500 if \$5 million or more. This fee is due within three months and 15 days after the close of the LLC's taxable year.
- If they have nonresident members, LLCs must file form FTB 3832, "Limited Liability Company's List of Members and Consents," with Form 568 and, if required, pay a "nonconsenting members' tax." The LLC's nonresident members who sign form FTB 3832 give their

## Limited Liability Companies: Registration Information

Your clients that plan to register as limited liability companies (LLCs) in California can obtain information from the California Secretary of State.

Both California and out-of-state clients can learn about organizing and registering LLCs here by writing: Limited Liability Company Unit, California Secretary of State, P.O. Box 944228, Sacramento, CA 94244-2280. Or call the unit at (916) 653-3795.

For more LLC information, see the article on this page. □

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## ***1996 Returns: Electronic Filing Calendar***

If you are still planning to file California tax returns electronically, keep these dates in mind:

**October 15:**  
Last day to file a 1996 electronic return.

**October 18:**  
Last day to retransmit a return rejected for errors. □

## ***Planning to Move?***

Do you plan to move soon?  
If there's a change of address in your future, be sure to alert Tax News.

Send your new address and telephone number to:

Tax News  
P.O. Box 520  
Rancho Cordova, CA  
95741-0520.

Also include the account number that you will find on page 16 of this issue above your name and address. □

# **Corporations with California Connections May Owe 1995 Returns**

Approximately 40,000 corporations that have not filed 1995 tax returns will receive demands to file next month.

Based on information that FTB receives from the Internal Revenue Service, Employment Development Department and State Board of Equalization, these corporations appear either to be doing business in California or to have income from a California source.

Included among the entities being asked for 1995 returns are "qualified" corporations that have registered with the California Secretary of State. These qualified corporations are required by law to file a California return each year until they either formally dissolve or withdraw.

Nonqualified corporations that have not registered with the Secretary of State will also be asked for 1995 returns. Along with the demands to file, nonqualified corporations will receive a questionnaire about their California business activity.

If the officials of a nonqualified

corporation believe that it does not have a California filing requirement, they must complete the entire questionnaire and return it to FTB. Then, based on the questionnaire information, FTB will determine whether the filing requirement exists.

If the questionnaire or other information shows that a corporation has a qualitatively or quantitatively nontrivial connection to California, then the corporation has a filing requirement. An activity is usually considered nontrivial if it is conducted regularly or systematically within California and if it is directed to establishing and maintaining a market here. Also, establishing that the corporation's activities account for only a relatively small part of the overall business conducted does not establish the activities as a nontrivial connection with California. □

## ***Limited Liability Companies***

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consent to California's jurisdiction to tax their pro rata share of income that is attributable to California sources.

If nonresident members do not sign the form, the LLC must pay the tax on their distributive share of income.

An LLC that fails to pay the nonresident members' tax is subject to penalties and interest. Any amount paid by the LLC on behalf of a nonresident member is considered a payment made by the member.

The LLC must compute the nonconsenting members' tax on Schedule T, included in Form 568. Multiply the distributive share of income by 9.3 percent, the maximum tax rate, if the member is an individual, a partnership or an estate or trust, by 8.84 percent if the member is a corporation and by 1.5 percent if the member is an S corporation.

- They may file any time through the

15<sup>th</sup> day of the 10<sup>th</sup> month following the end of the taxable year, which is the extended due date, if they are not able to file their California return by the original due date. California does not require LLCs to file a written request for an extension. However, the extension to file is not an extension to pay the annual fee or the nonconsenting members' tax. These amounts should be mailed on the return's original due date with Form 3537, "Payment Voucher for Automatic Extension for Limited Liability Companies."

LLCs are subject to penalties and interest charges for failing to follow filing and payment requirements:

- **Failing to file a return on time or failing to file required information on a return.** The penalty for each month or part of a month, up to five months, that the failure continues is \$10 multiplied by the total number of

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## Big Opportunities for Small Businesses

If you live in Orange, San Diego, Riverside or San Bernardino counties, you and your small business clients have an opportunity to pick up a wealth of tax information without charge.

Upcoming small business tax days will provide the information at a series of workshops and also at information booths. Participants include representatives of federal, state, county and city government agencies.

Mark your calendar and bring your questions and concerns to events on these dates:

- September 27 - Orange County.**  
 The Orange County Small Business Tax Day will be held at California State University, Fullerton from 9 a.m. to 3 p.m.  
  
 The Internal Revenue Service will present a workshop on "Federal Deposit Rules for Employment Taxes and Employment Tax Forms," and the Franchise Tax Board will offer "Small Business and Income Taxes." The Employment Development Department's Tax Branch programs are "Reporting Requirements and Major Tax Topics," "California Employer vs. Independent Contractor" and "Employer Contribution Rates." And the State Board of Equalization's topics are "Sales and Use Tax - Common Pitfalls" and "Preparing a Sales and

Use Tax Return." All four agencies will participate in a panel discussion of "Audits and Appeals."

In addition, the Orange County program will feature presentations on "Social Security Benefits and the Small Business Owner" by the Social Security Administration, "Financing Options" by the Small Business Administration, "Understanding the Business Property Statement" by the Orange County Assessor's Office and a compliance overview by CAL/OSHA. Many government agencies also will provide information at booths.

For more information, call (714) 461-5739.

- October 4 - San Diego County.**  
 You can attend the seventh San Diego County Small Business Tax Information Day at Point Loma Nazarene College from 9 a.m. to 3:30 p.m.  
  
 In addition to the EDD, FTB, IRS and SBE, participants in the event include San Diego's City Treasurer's Office, Contracting Opportunities Center and Small Business Development Center, as well as the San Diego County Assessor, Recorder and Public Library. Also on board are the Immigration and

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## Limited Liability Companies

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members in the LLC during the months the return is overdue. Interest is charged on the penalty from the date of the notice that the Franchise Tax Board sends the LLC. The exception to this penalty for LLCs classified as small partnerships for federal purposes does not apply for California tax purposes.

- Failing to pay the LLC fee on time, failing to pay the total nonresident members' tax on time or failing to pay the annual LLC tax on time.**  
 In all three cases, the penalty is 5 percent of the unpaid fee, plus 0.5 percent for each month or part of a month, but not more than 40 months,

that the fee is unpaid. Also, the penalty cannot exceed 25 percent of the unpaid fee. The penalty and interest are computed from the payment's due date.

For more information, see the Form 568 "Limited Liability Company Tax Booklet." For guidance on registering as an LLC in California, see the article on page 11. □

## Will More Taxpayers File Electronically?

Electronic filing is on the rise.

Although more paper and scannable returns were filed for the 1996 tax year, the number of electronically filed returns increased by 53 percent. And the Franchise Tax Board expects a 65 percent increase next year.

Next year's increase is anticipated primarily because of a new feature, the direct deposit of refunds. A second new feature for the 1997 tax year is the addition of Form 540NR, "California Nonresident or Part-Year Resident Income Tax Return," to the forms that can be filed electronically.

In addition, the notion of filing returns electronically is new to many people, including tax practitioners. But as more taxpayers become aware that the process produces a faster refund and that electronic filing saves paper, they are expected to join the ranks of the current electronic filers.

The process also is virtually error-free. Because the information on an electronically filed return is transferred automatically to the FTB's computer database, the risk of errors produced in keying the data into the system is eliminated.

For more information about electronic filing, contact FTB at its <http://www.ftb.ca.gov> Internet address. □

## ***Internet Has 1995 Median Income Data***

The Franchise Tax Board has posted on the Internet a complete county-by-county breakdown of 1995 taxpayers' median income (see "Study Shows 1995 Income Gain" on this page).

To access the information, contact FTB at its <http://www.ftb.ca.gov> Internet site. Then, see the July 1997 press release under either "Recent Additions" or "Other FTB Information." □

# **Study Shows 1995 Income Gain**

In 1995, four Bay Area counties continued their 24-year hold on California's highest median incomes, according to a study of state income tax returns for that year.

Median income represents income reported by a typical California individual or couple. Half of all tax returns report income above and half report income below the median point.

Marin, Contra Costa, Santa Clara and San Mateo counties captured the high-income honors for 1995. For joint returns, Marin County had the highest median income, which at \$66,962 was a 6.3 percent increase over 1994. Contra Costa County ranked second with \$59,638. Santa Clara County came in third with \$59,444, and San Mateo County was fourth with \$57,452. In terms of median income reported on all returns filed, Contra Costa County came in first, followed by Marin, San Mateo and Santa Clara.

The least populous county, Alpine, showed the greatest gain, 7 percent, in

median income reported on joint returns. Sierra County, the second smallest in the state in terms of population, showed the largest percentage gain in median income reported on all returns; the increase was 7.7 percent.

The statewide median income on all returns was \$24,128 in 1995, an increase of 3.2 percent over the previous year. For joint returns, the statewide median income was \$43,006, a 3.4 percent increase.

The study also shows that in 1995 Californians filed approximately 12.6 million state income tax returns and reported more than \$533 billion of adjusted gross income (AGI). The figure is 7.4 percent higher than 1994's AGI.

More than a quarter of all the tax returns were filed by Los Angeles County taxpayers. Coming in second to Los Angeles' 3.3 million returns was Orange County with close to 1.1 million, followed by San Diego, Santa Clara, Alameda and San Bernardino counties. □

## ***Big Opportunities for Small Businesses***

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Naturalization Service, CAL/OSHA, SCORE, Secretary of State, Small Business Development and International Trade Center, Small Business Institute of Point Loma College, Small Business Administration, Social Security Administration, State Compensation Insurance Fund and U.S. Department of Commerce.

For a brochure on the event, call (760) 744-1330, extension 410.

- **October 25 - Riverside/San Bernardino.** The Inland Empire Small Business Tax Day at the California Tower in Riverside will be open from 8:30 a.m. to 3 p.m.

Workshops include "Small Business Forms of Ownership, Record Keeping and Filing Requirements for Income Tax" by FTB; "The Audit and Appeals Procedures" by EDD, FTB, IRS and SBE; "Escrow - Sales of Business, Tax Clearance, Lien Releases, Etc." by FTB, IRS and

SBE; "Employee vs. Independent Contractor" by the IRS and EDD; "Employer Contribution Rates" and "Employer Reporting Rules and Major Tax Topics" by EDD; "Tax Tips for Restaurants" by SBE and IRS; "Understanding the Business Property Tax Statement" by Riverside and San Bernardino

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## **Small Business Tax Day Announced**

At press time, another Small Business Tax Day (see article beginning on page 13) was scheduled. It will be held in Van Nuys at Los Angeles Valley College on Saturday, October 18, from 8:30 a.m. to 3 p.m. For additional information, call (818) 901-5690. □

## Scannable Returns: Looking Good

A common error on "scannable" tax returns has nothing to do with itemized deductions, adjusted gross income, exemptions or other potential pitfalls. It involves entering the state name twice in the address section.

Scannable returns are computer-generated by tax practitioners and processed by the Franchise Tax Board's imaging equipment.

The common error on the scannable returns occurs when tax practitioners automatically, but incorrectly, add the state name right after the city name in the city field and then correctly enter it in the designated state field. All scannable tax forms have separate fields for city, state and zip code.

The error does not interrupt the processing of returns or delay any refunds. But it requires running a "clean-up" program to correct the computerized taxpayer database.

By press time, FTB's imaging equipment had processed 4.7 million 1996 scannable personal income tax returns, about 100,000 more than the previous year. Overall, the quality of the returns, produced by software packages, and the accuracy of the information that tax practitioners input have improved.

Even so, in addition to the incorrectly placed state designation, FTB has identified a few recurring errors. If you plan to send FTB scannable returns for your clients this year or next, here are some tips to follow:

- Print the apartment number in the apartment field. Do not add it to the street address field.
- Print the taxpayer's and/or spouse's middle initial in the middle initial field. Do not add a middle initial to the first name field.
- Mail the original, signed scannable return to FTB. Do not substitute a photocopy of the return.
- Mail the scannable return to the correct address.

If the return shows that a refund is due or that no amount is due, send it to Image Processing, Franchise Tax Board, P. O. Box 942840, Sacramento, CA 94270-0009.

If the return has a balance due, send

the return and the payment to Image Processing, Franchise Tax Board, P.O. Box 94267, Sacramento, CA 94267-0001. □

## Big Opportunities for Small Businesses

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Counties; "Disability and Worker's Compensation Costs" by the State Compensation Insurance Fund, EDD's Disability Insurance Branch and the Social Security Administration; "I-9 Verification Procedures" by the Immigration and Naturalization Service; and "Budgeting and Money Management" by the Consumer Credit Counseling Service. Also participating in the event are the Social Security Administration and the Greater Riverside Chamber of Commerce.

For more information, call (909) 680-6705. □

## Corporations: Take Credit Where Credit Is Due

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- Enter an amount on line 27 on Form 100 or on line 26 on Form 100S only when there is at least one entry on lines 23 through 25 on Form 100 or on lines 22 through 24 on Form 100S.
- Verify that the credit amounts have been added correctly and that the sum is entered on the correct line.
- Verify that the tax preparation software has not entered erroneous credits.
- Attach Schedule P (100) to the return if Form 100 is filed.
- Attach all supporting credit schedules. □

## SBE Opinions

**Appeal of CRG Holdings, Inc., formerly Charles of the Ritz Group, Ltd., May 8, 1997.** Taxpayer was not allowed to adjust its basis in its subsidiaries' stock based on a consent dividend properly declared pursuant to the Internal Revenue Code.

**Appeal of Kelly Service, Inc. and Subsidiary Corporations, May 8, 1997.** The Michigan Single Business Tax measures economic activity and is not an income tax. The tax may be deducted on a California franchise tax return even though the ultimate base upon which the tax is measured does not contain a return of capital in the context of a service-intensive business.

**Appeal of Rapid-American Corporation, Opinion on Rehearing, May 8, 1997.** No California authority exists that would support a parent corporation increasing its basis in the stock of a unitary subsidiary by the amount of the subsidiary's undistributed earnings and profits, even though those earnings and profits may have been included in a combined unitary return.

**Appeal of Michael E. Curtis, August 1, 1997.** A child and his mother live in the home and are dependents of an unrelated taxpayer who claims head of household filing status on the basis that the child is his qualifying individual. Because the child is in the care of his mother, the child is not a foster child and does not qualify the taxpayer for head of household filing status.

*At press time, case numbers had not been assigned to these opinions.* □

### ***Explore FTB's Internet Links***

The Franchise Tax Board's Home Page on the Internet provides links to other government agencies.

From the FTB site, you can reach the California Home Page and Web sites for the Employment Development Department, Internal Revenue Service, State Board of Equalization, State Controller's Office and Secretary of State.

You can locate FTB at its <http://www.ftb.ca.gov> Internet address. □

## **Are Adjustment and Examination the Same?**

Sometimes, the Franchise Tax Board makes adjustments to tax returns when they are processed. When the result is a greater tax liability for the taxpayer, does the adjustment constitute an examination? And does the taxpayer have appeal rights?

If the change occurs during processing, it is a "math verification" adjustment. These adjustments merely correct errors in math or failures to follow instructions. All the information needed to make the correction is either on the return, in the instructions or, in the case of California withholding adjustments, available from data that FTB receives from the Employment Development Department.

In these cases, the correctness of the figures reported on the return is not

questioned. So, an adjustment does not constitute an examination or audit of the return. As a result, there are no appeal rights as there would be under an examination.

However, an adjustment may lead to appeal rights in some cases. For example, FTB notifies taxpayers of any adjustments made to their returns. Then, a taxpayer who disagrees with the adjustment can telephone FTB at the number given on the notice. After talking with an FTB staff member, a taxpayer who still disagrees can pay the amount owed and file a formal claim for refund. If FTB denies the refund, the taxpayer may file an appeal with the State Board of Equalization. □